Two days before Christmas, the Securities Exchange Commission (SEC) gave GE and Alcoa leave to exclude from their 2012 annual meetings a shareholder proposal not to their liking, one calling for rotation of the companies' external auditors. Some weeks earlier, the commission did the same for Hewlett Packard, Walt Disney, and John Deere, and early in the New Year, for AT&T, General Dynamics, and others. This was all on the grounds that such proposals run counter to a decades-old rule excluding from proxy materials proposals that will affect firms' "ordinary business."

These episodes constitute the latest chapter of a longstanding controversy surrounding what is generally a thoroughly routine aspect of corporate governance - stockholder ratification of firms' choice of external auditors. Companies have been inviting investors to weigh in on this since the 1930s, and the great majority continues to do so today; yet, oddly enough, the shareholders' actual right to have a say on auditor selection has remained uncertain - notwithstanding the recommendation of a blue-ribbon Treasury commission in 2008 that annual shareholder ratification be mandatory.

**Overview**

A recent study - "**Shareholder Voting on Auditor Selection, Audit Fees, and Audit Quality**" [2] - published in the current issue of *The Accounting Review* [3], was conducted by Kannan Raghunandan, an accounting professor at Florida International University (FIU); Dasartha V. Rama, Professor and Knight Ridder
Research Fellow at FIU; and Mai Dao, an accounting professor at the University of Toledo. The objective of their study was to "examine the association between shareholder involvement in auditor selection and (1) audit fees, and (2) audit quality."

The motivation for the study came from the US Department of the Treasury's "Report of the Advisory Committee on the Auditing Profession (ACAP) to the U.S. Department of Treasury." In its report, the ACAP recommended that "all public companies must have an annual shareholder ratification of the external auditor." The ACAP justified its recommendation by stating, "annual submission of auditor selection for ratification enhances 'competition in the audit industry.'"

While the ACAP did not elaborate on the benefits that would result from increased competition among auditors, the traditional view of the courts, legislators, and regulators has been that competition in any sector leads to higher quality and lower price. Professors Raghunandan, Rama, and Dao stated, "We argue that any arrangement that strengthens the role of the shareholders in auditor selection also changes the incentives of the auditors and strengthens auditor independence."

**Study Results**

The study found that companies that put auditor selection to a shareholder vote are considerably less likely than those that do not to have to make financial restatements. Only 5.1 percent of the former group had to restate their results compared to 8.1 percent of the latter. And the difference is even more pronounced - 3.5 percent versus 6.1 percent - for restatements that are serious enough to lower the price of the company's stock, as measured by the five-day cumulative abnormal return surrounding the restatement announcement date.

In other words, firms that forego shareholder ratification are almost 75 percent more likely than others to have to issue restatements serious enough to have a negative effect on their stock price.

What accounts for this improvement in audit quality? "Shareholder involvement in auditor selection strengthens the power of the auditor in any negotiations with management and increases the 'pressure to perform' on the auditor," the study concludes. "If there is a shareholder vote, then questions will be raised if an auditor who routinely gets 98 percent ratification drops down to 95 or 90 percent support from shareholders." To prevent such an eventuality or the possibility, however remote, of a negative vote, "it is likely that auditors would spend extra effort and be more cautious in negotiations with the client."

"Most companies have been assuming for a long time that shareholder ratification is a good thing, and in this case, the companies have now been proven right," comments Raghunandan. "The oddity is that over the course of all these decades, no one ever thought of actually testing whether getting the stockholders involved makes a difference. Well, clearly it does, and, perhaps our findings will help motivate less wavering by regulators on this issue."

The study also finds that the higher quality of audits in companies that give
shareholders a say in auditor choice comes at a price, with those firms paying about 9 percent more on average than other companies. Since the median cost of an external audit among firms included in the study was about $1.5 million, on average, this amounts to a difference of about $135,000. Companies that submit auditor selection for shareholder ratification tend to be larger than those that do not; they are more likely to be audited by a Big 4 firm; and they are less likely to have adverse Section 404 reports, going-concern modified audit reports, or auditor changes.

The professors' findings emerged from an analysis of 1,382 companies included in a major corporate database for 2006, a year early enough to allow ample time for subsequent restatements of financial results. Some 1,036 companies, or about three-quarters of the total, had shareholder ratification of auditor choice. In all, eighty-one of the companies issued financial restatements, fifty-seven of which were serious enough to negatively affect their stock price. The study also found that abnormal accruals are lower.

Related articles:

- Good Error Analysis - A Key to Audit Quality [4]
- Not All Restatements Are the Same to the Stock Market [5]

Material for this article was supplied by the American Accounting Association as well as taken from the "Shareholder Voting on Auditor Selection, Audit Fees, and Audit Quality" report. The Accounting Review is published by the American Accounting Association [6].

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